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Ratification and the Derivative Action Under the Ontario Business Corporations Act

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Few doctrines of company law have been quite so persistent as the rule in *Foss* v. *Harbottle*,[1] under which an individual shareholder may not complain of those breaches of duty owed to his company which are ratifiable by a majority of shareholders.[2] On its authority, directors have been able to escape the consequences of their wrongs for more than a hundred and thirty years.[3] Recently, however, section 99 of the Ontario *Business Corporations Act*[4] has given dissenting

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1 (1843) 2 Hare 461, 67 E.R. 189.

2 The leading article on the rule remains that of K. W. Wedderburn, *Shareholders' Rights and the Rule in Foss* v. *Harbottle* (1957) Cambridge L.J. 194, (1958) Cambridge L.J. 93. For more recent Canadian studies of the rule, see S. M. Beck, "An Analysis of Foss v. Harbottle" in J. S. Ziegel (ed.), *Studies in Canadian Company Law* (1967), vol.1, 545; *The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered* (1971) 49 Can.Bar Rev. 80, 114 *et seq.*, reprinted with changes in J. S. Ziegel (ed.), *Studies in Canadian Company Law* (1973), vol.2, 193, 216; *The Shareholders' Derivative Action* (1974) 52 Can.Bar Rev. 159.

3 I have not considered the applicability of the rule to managers and majority shareholders. However, insofar as they owe duties to the company, it would seem that the rule and its exceptions extend to them as well: *Menier* v. *Hooper's Telegraph Works* (1874) L.R. 9 Ch.App. 350. Moreover, senior officers seem now to owe the same duties at law to their company as directors: *Canadian Aero Service Ltd* v. *O'Malley* [1974] S.C.R. 592. *Cf.* also the *Business Corporations Act*, R.S.O. 1970, c.53, ss.144-47.

4 R.S.O. 1970, c.53. *Cf.* also the *Companies Act*, S.B.C. 1973, c.18, s.222 and Manitoba's proposed legislation, *The Corporations Act*, Bill 37, 3d. Sess., 30th Leg., 1976.

shareholders an opportunity to bring derivative actions on behalf of their company to enforce the duties owed to it by its directors:

> s.99.(1) Subject to subsection 2, a shareholder of a corporation may maintain an action in a representative capacity for himself and all other shareholders of the corporation suing for and on behalf of the corporation to enforce any right, duty or obligation owed to the corporation under this Act or under any other statute or rule of law or equity that could be enforced by the corporation itself, or to obtain damages for any breach of any such right, duty or obligation.
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> (2) An action under subsection 1 shall not be commenced until the shareholder has obtained an order of the court permitting the shareholder to commence the action.
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> (3) A shareholder may, upon at least seven days notice to the corporation, apply to the court for an order referred to in subsection 2, and, if the court is satisfied that,
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> (a) the shareholder was a shareholder of the corporation at the time of the transaction or other event giving rise to the cause of the action;
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> (b) the shareholder has made reasonable efforts to cause the corporation to commence or prosecute diligently the action on its own behalf; and
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> (c) the shareholder is acting in good faith and it is *prima facie* in the interest of the corporation or its shareholders that the action be commenced,
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> the court may make the order upon such terms as the court thinks fit, except that the order shall not require the shareholder to give security for costs.
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> (4) At any time or from time to time while an action commenced under this section is pending, the plaintiff may apply to the court for an order for the payment to the plaintiff by the corporation of reasonable interim costs, including solicitor's and counsel fees and disbursements, for which interim costs the plaintiff shall be accountable to the corporation if the action is dismissed with costs on final disposition at the trial or on appeal.
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> (5) An action commenced under this section shall be tried by the court and its judgment or order in the cause, unless the action is dismissed with costs, may include a provision that the reasonable costs of the action are payable to the plaintiff by the corporation or other defendants taxed as between a solicitor and his own client.
>
> (6) An action commenced under this section shall not be discontinued, settled or dismissed for want of prosecution without the approval of the court and, if the court determines that the interests of the shareholders or any class thereof may be substantially affected by such discontinuance, settlement or dismissal, the court, in its discretion, may direct that notice in manner, form and content satisfactory to the court shall be given, at the expense of the corporation or any other party to the action as the court directs, to the shareholders or class thereof whose interests the court determines will be so affected.

The section must now be compared with the more ambitious provisions of the *Canada Business Corporations Act.*[5] The Canadian Act permits a "complainant" to apply to a court to bring a derivative action under section 232 or to seek relief from oppression under section 234. Unlike section 99(3)(a) of the Ontario Act, the Canadian Act does not require contemporaneous ownership, giving a court discretion to allow anyone falling under the definition of "complainant" in section 231 to bring an action. While the Ontario Act is silent on the question of ratification, the Canadian Act states in section 235(1):

> An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section ... 233 or 234.

The new Ontario remedy has been criticized for a variety of reasons.[6] Because of the procedural requirements of section 99(3), a derivative action will likely now be more costly and time-consuming than at common law under the exceptions to the rule in *Foss* v. *Harbottle.*[7] The shareholder must also show that it is *prima facie* in the interest of the corporation or its shareholders that the action be commenced at a time when he may have little or no access to details of corporate wrongdoing. In imposing these restrictions, the intention of the Select Committee on Company Law,[8] which drafted the bill, was clearly to avoid strike suits. A company must be protected from a "cantankerous member"[9] whose love of litigation injures the company (and its shareholders) more than it benefits the shareholders. In the past, these fears would seem to have been misplaced. In most cases, ordinary court costs[10] and the prohibition against contingent fees[11] served as an adequate deterrent to harassing litigation; and, as a matter of substantive law, the rule in *Foss* v.

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[5] S.C. 1974-75, c.33.

[6] *Cf.* T. A. Zacks, Comment (1973) 8 U.B.C.L.Rev. 191 and S. M. Beck, *The Shareholders' Derivative Action* (1974) Can.Bar Rev. 159, 196 *et seq.*

[7] See *infra*, "The exceptions to Foss v. Harbottle", at 178.

[8] 1967 Interim Report, 5th Sess., 27th Leg., 15-16 Eliz.II, 62-63 (hereinafter called *The Lawrence Report*).

[9] *MacDougall* v. *Gardiner* (1875) 1 Ch.D. 13, 25 *per* Mellish L.J. *Cf.* also *Cie de Mayville* v. *Whitley* [1896] 1 Ch. 788, 807 *per* Kay L.J.

[10] See L.C.B. Gower, *Company Law — Minority Stockholder's Suits* (1950) 19 M.L.R. 538, 541.

[11] See *The Lawrence Report, supra*, note 8, 63. *Cf.* also W. B. Williston, *The Contingent Fee in Canada* (1968) 6 Alta L.Rev. 184.

Harbottle seldom permitted recovery in derivative actions. But under section 99 this may no longer be the case. Moreover, subsection (4) provides for an order of interim costs, including solicitor's and counsel fees, contingent upon success or an award of costs in the principal action. Under these circumstances, a requirement that an initial *prima facie* case be made, showing that the action is for the benefit of the company, may not be unreasonable. The section should not be used for fishing expeditions where there is no evidence that the director has committed a breach. How a shareholder learns of the affairs of the company is in general a separate question, determined by separate sections of the Act.[12] It is hardly necessary to add that a full disclosure of business matters to shareholders may not be in the company's interests. In any event, there is some flexibility in the wording of section 99(3)(c): it does not require the plaintiff to make out his case at the pre-trial hearing, but merely to show that the action should be *commenced*.[13] In appropriate cases, a judge may therefore permit a shareholder to use discovery devices where he has not fully made out a *prima facie* case. Finally, it must always be remembered that even where a director is clearly in breach of his duties, the prosecution of the action may be disadvantageous to the company and its shareholders. A trifling breach of the duty of care, which causes only nominal loss, should not be the subject of the elaborate machinery of section 99.[14]

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[12] *Business Corporations Act, supra,* note 4, ss.172-188.

[13] *Re Marc-Jay Investments Inc.* (1974) 5 O.R. (2d) 235; see also *Feld* v. *Glick* (1975) 56 D.L.R. (3d) 649 (Ont. H.C.).

[14] See R. N. Leavell, *The Shareholders as Judges of Alleged Wrongs by Directors* (1961) 35 Tulaine L.Rev. 331, 348: "A suit against a corporation's director ... even if successful, can sometimes ... do the corporation more harm than good: his services may be lost; the standing of the corporation in financial circles may be adversely affected; public relations may suffer; the value of the shares may be adversely affected in the market; prosecution of the action may be expensive to the corporation." See also *S. Solomont & Sons Trust* v. *New England Theatre Operating Co.* 93 N.E. 2d 241 (1950, Mass.Sup.Jud.Ct); *Pomerantz* v. *Clark* 101 F.Supp. 341 (1951, D.Mass.). A similar problem was suggested in *Claman* v. *Robertson* 164 O.St. 61, 128 N.E. 2d 429 (1955). Can a director, as a shareholder, bring an action to avoid a contract between himself and his company, where in spite of strict equitable rules which make the contract voidable at the option of the company, the contract has actually turned out to be profitable for it? If he cannot, can any other shareholder do so? As a result of these difficulties, American courts have granted "disinterested" directors a considerable discretion to prevent a derivative action: see *Swanson* v. *Traer* 249 F.2d 854 (1957, 7th C.C.A.).

PERSONAL ACTIONS

More serious problems arise with respect to the scope of section 99. Until recently, its principal effect would seem to have been in preventing rather than permitting derivative actions. In *Farnham* v. *Fingold* the Ontario Court of Appeal held that "the very broad language of s.99(1) embraces all causes of actions under any statute or in law or in equity, that a shareholder may sue for on behalf of the corporation".[15] Since the plaintiffs had not applied for leave under section 99(3), the Court did not consider the merits of their claim for a declaration that the defendant shareholders held the premium obtained on a sale of controlling shares of their company for the benefit of the company or its shareholders. The *Farnham* decision was followed by the Ontario High Court in *Goldex Mines Ltd* v. *Revill.*[16]

The *Goldex* decision was affirmed by the Court of Appeal,[17] but Brooke J.A. *per curiam* adopted to a large extent the critical analysis of the previous decisions by Professor Beck.[18] Professor Beck argued that if derivative actions must now be brought under section 99, the section does not purport to affect personal actions by shareholders, which may be brought without leave. A personal action lies where a legal wrong is done to a shareholder or a group of shareholders of the company. "A derivative action, on the other hand, is one in which the wrong is done to the company."[19] But since *Foss* v. *Harbottle* it has been thought that directors' duties are in general owed to their company and not to its shareholders. A shareholder's remedy for a director's breach would then in most cases only lie under section 99.

However, after arguing that personal actions need not be brought under section 99, Professor Beck suggested that "the personal rights category is in fact much broader than has been thought to be the case".[20] The most interesting aspect of the decision of the Court of Appeal in *Goldex* is its delicate flirtation with Professor Beck's argument that directors may owe fiduciary duties to shareholders, particularly in the realm of the "proper purposes" doctrine.[21] If directors' duties to act *bona fide* in the interests of the company as

[15] [1973] 2 O.R. 132, 135 *per* Jessup J.A.
[16] [1973] 3 O.R. 869.
[17] (1974) 7 O.R. (2d) 216.
[18] *The Shareholders' Derivative Action* (1974) 52 Can. Bar Rev. 159.
[19] (1974) 7 O.R. (2d) 216, 221.
[20] (1974) 52 Can.Bar Rev. 159, 170.
[21] (1974) 7 O.R. (2d) 216, 222.

a whole and not purely for their personal objectives may be enforced by personal actions by shareholders, it is not clear why other duties are owed only to the company. Is there any sense in which a breach of the proper purposes rule is more "personal" than breaches of the duties to act in good faith and with care and skill? The difficulty with the distinction between personal and derivative actions is that *every* injury to a company causes an injury to its shareholders. Brooke J.A. would certainly require more than such an indirect injury to a shareholder to entitle him to sue.[22] However, the case does suggest the possibility that directors owe fiduciary duties to shareholders, who may bring personal actions to enforce such duties without obtaining leave under section 99. But this remains a mere possibility, whose occurence would effect a revolution in Canadian company law. There are as well eminently practical reasons why not every breach by a director should give rise to a shareholder's private right of action. In many cases, shareholder actions, if permitted, would harm a company and its shareholders.[23] A screening device, such as section 99(3) of the Ontario Act may then be very useful. Private rights may lead to a multiplicity of suits by each injured shareholder. Private actions for the benefit of individual shareholders also defeat the prior claim of creditors of the corporation, since recovery in such cases is personal and not corporate. Finally, private rights may lead to private settlements, with the faint suggestion of blackmail in the background. Such settlements are unlikely under section 99(6) of the Ontario Act.[24]

One may therefore expect that directors will continue to owe duties to their companies which are not owed directly to their shareholders. In such cases, the statutory remedy under section 99 is exclusive. That is not to say, however, that the substantive rule in *Foss* v. *Harbottle* is obsolete, although one may sympathize with the hope of Hughes J. that, as a result of section 99, "it is to be expected that much labour will be saved at the bench and bar in this Province in raking the embers of abundant learning generated over the years by *Foss* v. *Harbottle*".[25] Notwithstanding section 99 the courts may view derivative actions with the same disfavour as before. Firstly, the section does not prescribe the circumstances under which an action may be brought. Secondly, unlike the *Canada Business Cor-*

[22] *Ibid.*, 223.
[23] *Cf.* R.N. Leavell, *supra*, note 14.
[24] For the American position see *Watson* v. *Button* 235 F.2d 235 (1956, 9th C.C.A.) and C.K. Crosno, Note, (1952) 40 Calif.L.Rev. 127.
[25] *Goldex Mines Ltd* v. *Revill* [1973] 3 O.R. 869, 877.

porations Act,[26] section 99 says nothing of ratification. As a result, one may presumably ratify any breach which could have been ratified before the passage of the new Act.[27] Finally, and most importantly, the possibility of ratification may determine the right to bring a derivative action: a court may hesitate to permit an action which may subsequently be undone by the company shareholders. This "futility principle" was, after all, a principal basis for the decision in *Foss* v. *Harbottle*. Thus the courts may still be forced to return to the old learning of the cases when directors seek to avoid liability for their breaches.

THE RULE IN FOSS v. HARBOTTLE

The rule in *Foss* v. *Harbottle* is one which, but for certain exceptions, prohibits a suit brought by an individual shareholder to remedy a wrong done to the corporation. "In law the corporation and the aggregate members of the corporation are not the same thing for purposes like this."[28] If it is alleged that the company has suffered at the hands of a director, the proper plaintiff in an action to remedy the injury is the corporation itself.[29] But the rule involves more than a mere question of standing. If a company may sue its directors, it may also ratify their breaches of duty through a majority vote of shareholders in general meeting. The result is that

> [w]hilst the court may be declaring the acts complained of to be void at the suit of the ... [individual shareholders], who in fact may be the only proprietors who disapprove of them, the governing body of proprietors may defeat the decree by lawfully resolving upon the confirmation of the very acts which are the subject of the suit.[30]

A mere possibility of ratification therefore prevents a shareholder from suing a director for a breach of duty to his company.

As a result, much of the work of regulating a company's directors was left to a majority of its shareholders. Courts were reluctant to intervene in the "internal management" of a company, whose direc-

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[26] *Supra*, note 5, s.235.

[27] Personal rights of shareholders cannot be lost by ratification, being an "exception" to the rule in *Foss* v. *Harbottle*: See *infra*, at 178.

[28] (1843) 2 Hare 461, 490; 67 E.R. 189, 202 *per* Wigram V.C.

[29] *Burland* v. *Earle* [1902] A.C. 83, 93 *per* Lord Davey (P.C.); *Edwards* v. *Halliwell* [1950] 2 All E.R. 1064, 1066 *per* Jenkins L.J. (C.A.).

[30] (1843) 2 Hare 461, 494; 67 E.R. 189, 203-4 *per* Wigram V.C. On the two branches of the rule, see K. W. Wedderburn, *supra*, note 2. See also *MacDougall* v. *Gardiner* (1875) 1 Ch.D. 13, 25 *per* Mellish L.J.; *North-West Transportation Co.* v. *Beatty* (1887) 12 App.Cas. 589, 593-94 *per* Sir Richard Baggallay (P.C.); *Burland* v. *Earle*, *ibid.*, *per* Lord Davey (P.C.); and *Edwards* v. *Halliwell*, *ibid.*

tors and members were assumed to have far greater expertise in the conduct of its affairs than judges. In 1843, that may well have been the case. But today few commentators would credit ordinary shareholders with much knowledge of their company.[31] They are seen rather as mere *rentiers* of capital, interested only in the security and return on their investment, and hardly capable of casting an intelligent vote in the ratification of a director's breach.[32] However, even were this not the case, conflicts of interests between controlling shareholders or directors and minority shareholders may justify intervention by the courts. In these cases, an abdication of judicial

[31] The impotence of the average shareholder was first demonstrated in T. Veblen, *Absentee Ownership and Business Enterprise in Recent Times: The Case of America* (1923); Ripley, *Main Street and Wall Street* (1927); and the classic treatise of A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (1932). Since then, the topic has received wide attention throughout the common law world. See B. Manning, Book Review (1958) 67 Yale L.J. 1477; *Corporate Power and Individual Freedom: Some General Analysis and Particular Reservations* (1961) 55 Nw. U.L. Rev. 38; M. A. Pickering, *Shareholders' Voting Rights and Company Control* (1965) 81 L.Q.R. 248, 269 *et seq.;* and B. Hindley, *Separation of Ownership and Control in the Modern Corporation* (1970) 13 J. of Law and Econ. 185.

Some writers are, however, still willing to rally round the doctrine of Corporate Democracy: See F. D. Emerson and F. C. Latcham, *Shareholder Democracy* (1954); F. A. von Hayek, "The Corporation in a Democratic Society: In Whose Interest Ought It and Will It be Run?" in Aushen and Bach (eds), *Management and Corporations 1985* (1960), 99; and N.W. Chamberlain, *The Limits of Corporate Responsibility* (1973). It is sometimes argued that the rise of institutional investors in the last two decades will offer a greater protection to minority shareholders, although that proposition has not passed without criticism: see D. L. Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of 'One Share, One Vote'* (1971) 56 Cornell L.Rev. 1. *Cf.* M. A. Eisenberg, who argues that commentators have been misled by "the A.T. & T. myth", and that many shareholders have a sufficient investment in their company to entitle them to have a say in corporate decisions: *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking* (1969) 57 Calif.L.Rev. 1.

[32] Several commentators have suggested that one might therefore do away with shareholder voting rights altogether: B. Manning, Book Review, *ibid.*, 1486-90; A. Chayes, "The Modern Corporation and the Rule of Law" in E. S. Mason (ed.), *The Corporation in Modern Society* (1959), 25. This has been criticized by H. G. Manne, who argues that shareholder voting rights are necessary to preserve the market for corporate acquisitions, which in turn is a useful incentive to managerial efficiency: *The "Higher Criticism" of the Modern Corporation* (1962) 62 Colum.L.Rev. 399; *Some Theoretical Aspects of Share Voting* (1964) 64 Colum.L.Rev. 1427; and *Mergers and the Market for Corporate Control* (1965) 73 J. of Pol. Econ. 110. But *cf.* A. A. Berle, *Modern Functions of the Corporate System* (1962) 62 Colum.L.Rev. 433 and D. C. Morse, *Economic Realities of Cash Tender Offers* (1968) 20 Maine L.Rev. 237.

control to majority rule is entirely inappropriate. In a close corporation, a minority shareholder may find it impossible to prevent the ratification of a breach because of the voting control of the transgressor. Where the company's shares are widely held, a dissenting shareholder is not likely to have the financial resources or the support of the other shareholders to wage a campaign to prevent ratification. By contrast, the controlling shareholders or directors are highly organized, and can usually obtain the forgiveness of their sins through their control of the proxy apparatus.

RESTRAINTS ON AVOIDING LIABILITY THROUGH RATIFICATION

1. Close corporations

While the principle of noninterference in internal company affairs seems to have been derived from partnership law,[33] the courts have been less willing to apply to shareholders the duties of good faith which partners owe to each other.[34] A suggestion has been made in a few cases that majority shareholders must exercise their powers as fiduciaries. Thus in *Allen* v. *Gold Reefs of West Africa Ltd* Lindley M.R. stated that the majority must exercise its voting powers "bona fide for the benefit of the company as a whole".[35] However, that restriction seems now to be limited to the special case of an amendment to the articles of the company.[36] In other cases, the rule is in general that stated by Jessel M.R. in *Pender* v. *Lushington*:[37]

> There is, if I may say so, no obligation on a shareholder of a company to give his vote merely with a view to what other persons may consider the interests of the company at large. He has a right, if he thinks fit, to give his vote from motives or promptings of what he considers his own individual interest.[38]

The case most often cited for this rule is *North-West Transportation Co.* v. *Beatty*,[39] in which a director sold to his company a steamer

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[33] See K. W. Wedderburn, *supra*, note 2.

[34] *Blisset* v. *Daniel* (1953) 10 Hare 493, 536; 68 E.R. 1022, 1040.

[35] [1900] 1 Ch. 656, 671 (C.A.). See also *Ritchie* v. *Vermillion Mining Co.* (1902) 4 O.L.R. 588, 604 *per* Moss J.A.

[36] Or where class rights are provided for bondholders in a trust deed: *British America Nickel Co.* v. *M. J. O'Brien Ltd* [1927] A.C. 369 (P.C.). See generally B. H. McPherson, *Oppression of Minority Shareholders* (1963) 36 A.L.J. 404.

[37] (1877) 6 Ch.D. 70. But *cf.* the discussion on *Menier's* case, *infra*, at 183.

[38] *Ibid.*, 75-76.

[39] (1887) 12 App.Cas. 589 (P.C.); rev'g (1886) 12 S.C.R. 598; aff'g (1885) 11 O.A.R. 205; rev'g (1883) 6 O.R. 300.

which he had built and owned. While the director acted in good faith and the contract would seem to have been fair, it was voidable under the rule in *Aberdeen Rail. Co.* v. *Blaikie Bros.*[40] However, the director controlled 301 of the 600 issued shares of the company, and *qua* shareholder procured the ratification of the contract at a general meeting of the company. In the Supreme Court of Canada, it was held that the rule in *Pender* v. *Lushington* did not apply where a shareholder, as a director, owed special duties to his company. The judgment was reversed by the Privy Council, Sir Richard Baggallay stating that

> ... every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject-matter opposed to, or different from, the general or particular interests of the company.[41]

There is consequently little to prevent a controlling shareholder in a close corporation from avoiding all liability for ratifiable breaches.

2. Widely-held corporations

In a widely-held company different problems arise. The element of control by management may be based not on ownership of shares but solely on its entrenched position. "[C]ontrol may be held by the directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a small fraction of the stock outstanding."[42] While any shareholder may send out proxies, at law only the directors may do so at the expense of the company.[43] The proxy apparatus has there-

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[40] (1854) 1 Macq.H.L. 461 (Sc.), [1843-60] All E.R. Rep. 249.

[41] (1887) 12 App.Cas. 589, 593 (P.C.). See also *Ritchie* v. *Vermillion Mining Co., supra,* note 35, 594-95 *per* MacLennan J.A.; *Dominion Cotton Mills Co.* v. *Amyot* [1912] A.C. 546 (P.C.).

[42] A. A. Berle and G. C. Means, *supra,* note 31, 5.

[43] *Peel* v. *London and North Western Ry. Co.* [1907] 1 Ch. 5 (C.A.); *Campbell* v. *Australian Mutual Provident Soc.* (1908) 77 L.J.P.C. 117. Under s.102 of the *Business Corporations Act, supra,* note 4, shareholders holding 5% of the voting shares may require that a proposed shareholder resolution with a statement of not more than 1,000 words be sent to all shareholders before a shareholder meeting. The shareholders must give security for costs, which will not be repaid unless they obtain the support of the majority of shareholders. A similar right exists with respect to a requisition for a general meeting; s.109. Because of the need for the initial support of 5% of the shareholders and the approval of a majority for reimbursement, neither provision is likely to be used except in a takeover bid.

S. 131 of the *Canada Business Corporations Act, supra,* note 5, which closely resembles SEC Rule 14a-8, does away with both difficulties for shareholder proposals. S. 137 of the Act gives shareholders substantially the same right to requisition a meeting as the Ontario Act.

fore been the subject of substantial regulation in both the United States and Canada. Under the Ontario Act, every proposal by management in a proxy must be accompanied by a brief discussion of the substance of the matter "in sufficient detail to permit shareholders to form a reasoned judgment concerning any such matter".[44] Moreover, a special duty of disclosure is required at law of directors who seek to ratify a breach: "Ratification consists in adopting something which has been done or assumed to have been done for the person ratifying with full knowledge that it has been done."[45] The requirement of full disclosure is by definition a necessary condition of ratification, quite apart from the proxy rules. Thus in *Pacific Coast Coal Mines, Ltd* v. *Arbuthnot*[46] a shareholder resolution which released the directors of a company from its claims against them was set aside by the Privy Council for lack of adequate disclosure to the shareholders:

> If the shareholders were to release possible claims, they ought to have been told of the grave character which ... [had been] attributed to the circumstances out of which [it was] alleged that they had arisen. Nor was there anything to tell them that as the result of the settlement [one of the directors] ... would quit the company with large profits in his pocket.[47]

An adequate notice should therefore not only describe the breach, but also specify all profits or commissions made by a director through it.[48]

Proxy rules present courts with a procedural device with which they may invalidate unfair shareholder resolutions. The rules also provide shareholders with their most useful source of information about the company.[49] And yet, doubts remain. Even the fullest disclosure to shareholders may not protect the company adequately from a rapacious management:

> Perhaps the most serious charge against the myth of shareholder democracy is that its slogans do much to create an impression in the public mind... that a degree of shareholder supervision exists which in fact does not. It is quite arguable that the net effect of the corporate Jacksonians

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[44] *Business Corporations Act, supra,* note 4, s.118(1)(a) and Ont.Reg. 492/70, Form 15, Item 10. *Cf.* also *Canada Business Corporations Act, supra,* note 5, s.143 and SOR/76-22, s.33 *et seq.* Apart from the statutes, a substantial duty of disclosure exists at law: *Garvie* v. *Axmith* (1961) 31 D.L.R. (2d) 65 (Ont. H.C.).

[45] *Ashbury* v. *Watson* (1885) 30 Ch.D. 376, 381 *per* Lord Esher M.R.

[46] [1917] A.C. 607 (P.C.).

[47] *Ibid.,* 618 *per* Viscount Haldane. See also *Gray* v. *Yellowknife Gold Mines Ltd (No.1)* [1947] O.R. 928, 962 *per* Laidlaw J.A.

[48] See also *Rountree* v. *Sydney Land and Loan Co.* (1908) 39 S.C.R. 614.

[49] L. Loss, *Securities Regulation* 2d ed. (1961), vol.II, 1027.

has been to impede their ultimate objective of responsible corporate management. The forms and mechanisms of shareholder democracy divert attention from the real problem of holding business managements to a desirable standard of responsibility ... . The reform efforts of the Corporate Democrats, seen in this light, appear fundamentally misplaced, misdirected and romantic.[50]

3. The exceptions to Foss v. Harbottle

In *Foss* v. *Harbottle* itself, Wigram V.C. held that some breaches are incapable of majoritarian ratification.[51] The rule is therefore said to be subject to various exceptions, of which the classic enumeration is that of Jenkins L.J. in *Edwards* v. *Halliwell:*[52]

(1) "where the act complained of is wholly *ultra vires* the company ...";
(2) where "the personal and individual rights of membership ... have been invaded...";
(3) where the matter is "one which could validly be done or sanctioned not by a simple majority of the members of the company ... but only by some special majority ..."; and
(4) "where what has been done amounts to ... a fraud on the minority and the wrongdoers are themselves in control of the company...".[53]

In addition to these exceptions, Professor Gower has suggested that ratification is impossible "where the interests of justice require that the general rule ... should be disregarded".[54] While such a rule was expressly rejected by Danckwerts J. in *Pavlides* v. *Jensen,*[55] and by the Ontario High Court in *Ellis* v. *McQueen,*[56] other Canadian decisions have been less reluctant to accept a fifth exception.[57] In *Teck Corp.* v. *Millar,* for example, Anderson J. held that a minority shareholder might sue on that basis.[58] A court may therefore be forced to consider basic questions of fairness and justice where an attempt is made to ratify a director's breach.

[50] B. Manning, Book Review, *supra,* note 31, 1489-90.

[51] (1843) 2 Hare 461, 492, 67 E.R. 189, 203.

[52] [1950] 2 All E.R. 1064 (C.A.).

[53] *Ibid.,* 1067.

[54] L.C.B. Gower, *The Principles of Modern Company Law* 3d ed. (1969), 585.

[55] [1956] Ch. 565; *cf.* L. S. Sealy, *Cases and Materials in Company Law* (1971), 693.

[56] (1967) 63 D.L.R. (2d) 678.

[57] *Waddell* v. *The Ontario Canning Co.* (1889) 18 O.R. 41, 49-50 *per* Robertson J.; *Charlebois* v. *Bienvenu* (1967) 64 D.L.R. (2d) 683, 695 *per* Fraser J. (Ont. H.C.); rev'd on other grounds (1968) 68 D.L.R. (2d) 578; and *Schiowitz* v. *I.O.S. Ltd* (1971) 23 D.L.R. (3d) 102, 120 *per* Hughes J.A. (N.B. C.A.). See also *Wallersteiner* v. *Moir (No.2)* [1975] 1 Q.B. 373, 390-91 *per* Lord Denning M.R. (C.A.).

[58] Unreported judgment, 23 June, 1972, no.16244 (B.C. S.C.); *cf.* the Court of Appeal decision, (1972) 33 D.L.R. (3d) 288, 292-93 *per* Berger J.

These are only exceptions to the first branch of the rule in *Foss* v. *Harbottle,* which prohibits an action by an individual shareholder in matters of internal corporate management. They are not exceptions to the rule against shareholder action where ratification is possible, since a breach which may be subsumed under any one of the exceptions is not capable of ratification by a simple majority of shareholders.[59]

A right of action under the first three exceptions is personal, and is not affected by section 99.[60] Notwithstanding the decision in *Goldex Mines Ltd* v. *Revill,* actions brought under either of the last two exceptions are derivative and must comply with the requirements of that section. But decisions which upheld the right of shareholders to bring derivative actions in the past are still relevant in determining whether a breach may be ratified. If a derivative action was not allowed, ratification was then and is likely still permitted. The converse, as pointed out above,[61] is that the determination of whether or not a breach is ratifiable may be the criterion of whether a derivative action is permitted under section 99. The vexed question of the distinction between ratifiable and non-ratifiable breaches would then have lost none of its importance.

RATIFIABLE BREACHES

1. Care and skill

Of the director's duties, the least exacting has generally been his obligation to use care and skill in discharging his functions. Even where a director was grossly negligent in selling company assets at an undervalue, his breach was held capable of ratification.[62]

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[59] *Cf. Foss* v. *Harbottle, supra,* note 1, and *Ashbury Ry. Carriage and Iron Co.* v. *Riche* (1875) L.R. 7 H.L. 653 (*ultra vires*); and *Pender* v. *Lushington, supra,* note 37, 81 *per* Jessel M.R. (personal rights).

[60] A shareholder's right to ensure that company statutes or articles are complied with is personal: *Pender* v. *Lushington, supra,* note 37; *Hutton* v. *West Cork Ry. Co.* (1883) 23 Ch.D. 654 (C.A). A group of shareholders with personal causes of action against their company may sue as a class under Rule 75 of the Ontario Rules of Practice. Their representative or class action must, however, be distinguished from the derivative action of a shareholder whose claim is on behalf of his company and not himself; see *Farnham* v. *Fingold* [1972] 3 O.R. 688 and J. A. Kazanjian, *Class Actions in Canada* (1973) 11 Osgoode Hall L.J. 397; see also *infra,* note 64.

[61] See *supra,* at 173.

[62] *Pavlides* v. *Jensen, supra,* note 55. A director may not be indemnified for any liability in connection with the execution of his duties under s.147 of the

While one might hope for a wider scope of liability under the restatement of the duty in section 144 of the Ontario Act, there is nothing to suggest that a director's careless acts may not be ratified. The principal impetus to managerial efficiency is not the derivative action but the market for corporate takeovers.

2. Breaches of authority

Like ordinary agents, directors may not act in excess of their authority.[63] When they do, such breaches of authority may normally be ratified by the corporation.[64] But where the breach is of the articles of a company, the cases are in complete disarray.[65] The articles have been held to constitute a contract, under which shareholders have personal rights against the company.[66] In addition, a special majority is required in all jurisdictions in Canada to alter the articles

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Ontario Act, *supra*, note 4. However, unlike indemnification, ratification is not usually thought merely to save the director from the consequences of a breach. Rather, it nullifies the breach: F.M.B. Reynolds and B. J. Davenport (cds), *Bowstead on Agency* 13th ed. (1969), 57. The *Canada Business Corporations Act, supra*, note 5, s.117(3) goes further in providing that no resolution may relieve a director from liability for a breach of his duties under the Act or the Regulations. This might make ratification impossible in these cases, although it may be possible to draw a distinction between relief from the consequences of a breach and its nullification by ratification. The very broad ambit of s.117(3) certainly encourages such an interpretation. The alternative would appear to result in an absolute prohibition of ratification, except in those few cases where duties at law cannot be found in the statute.

[63] *Picard* v. *Revelstoke Saw Mill Co.* (1913) 12 D.L.R. 685 (B.C. C.A.), var'g (1913) 9 D.L.R. 580.

[64] *Irvine* v. *Union Bank of Australia* (1877) 2 App.Cas. 366; *Grant* v. *United Kingdom Switchback Rys. Co.* (1888) 40 Ch.D. 135 (C.A.); *Adams* v. *Bank of Montreal* (1903) 32 S.C.R. 719; *Bamford* v. *Bamford* [1970] Ch. 212, 239-40 *per* Harman L.J. (C.A.).

A distinction must of course be drawn between an ordinary breach of the director's authority and an act *ultra vires* the company which cannot be ratified; see *Cie de Villas du Cap Gibraltar* v. *Hughes* (1884) 11 S.C.R. 537 *per* Ritchie C.J.

[65] See K. W. Wedderburn, *supra*, note 2, 210 *et seq.* and S. Chumir, *Challenging Directors and the Rule in Foss* v. *Harbottle* (1965) 4 Alta L.Rev. 96.

[66] The doctrine of the contractual effect of the articles is of English origin; see *Hickman* v. *Kent or Romney Marsh Sheepbreeders' Ass'n* [1915] 1 Ch. 881 and cases cited therein. Some doubt has therefore been cast upon its applicability to Canadian letters patent jurisdictions. However, F. W. Wegenast stated "that the relationship established by the letters patent may be regarded as contractual in effect if not in origin": *Law of Canadian Companies* (1931), 247. The cases on point are not as clear as one might wish; see S. M. Beck, "An Analysis of Foss v. Harbottle", *supra*, note 2, 581 *et seq.*

of a company for most if not all purposes.[67] These breaches would therefore appear to be examples of the third exception to *Foss* v. *Harbottle,* and incapable of ratification by a simple majority.[68] However, other cases have suggested a distinction between altering and ratifying a breach of the articles.[69]

In his detailed study of the question, Professor Wedderburn argues that previous explanations of the different results in the cases are unsatisfactory, and suggests a rule of exclusion: a shareholder has in general the right to enforce the articles except in cases where a court has denied such a right in a similar case.[70] Unfortunately, one may argue with equal authority that the rule works the other way: any breach may be ratified except those where individual shareholder suits were permitted. However, both rules are quite nominalistic and neither is a satisfactory solution to the question.

3. Mere irregularities

Shareholders may not complain of a "mere informality or irregularity which can be remedied by the majority".[71] The *locus classicus* of this rule is *MacDougall* v. *Gardiner,*[72] where a director, as chairman of a shareholders' meeting, refused a poll on a vote of adjournment. The plaintiff argued that this was done to stiffle a shareholders' revolt, and that it was contrary to the articles of the company. The defendants demurred, and the Court of Appeal held that, notwithstanding the alleged breach of the articles, the plaintiff had no cause of action:

> [N]othing connected with internal disputes between the shareholders is to be made the subject of a bill by one shareholder on behalf of himself and others, unless there be something illegal, oppressive or fraudulent... on the part of the company ... or ... the majority of the company... .[73]

This ignores, of course, problems created by other exceptions to *Foss* v. *Harbottle.* It is not enough to label a breach of the articles as a mere irregularity — one must also distinguish irregularities

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[67] *E.g., Business Corporations Act, supra,* note 4, s.189; *Canada Business Corporations Act, supra,* note 5, s.167.

[68] Although no case has held that a director who votes as a shareholder in such a situation is subject to any fiduciary duties apart from the requirement of a special majority.

[69] See *Grant* v. *United Kingdom Switchback Rys. Co., supra,* note 64, 139 and the other cases cited in note 64.

[70] K. W. Wedderburn, *supra,* note 2, 214-25.

[71] *Burland* v. *Earle, supra,* note 20, 93-94 *per* Lord Davey (P.C.).

[72] (1875) 1 Ch.D. 13.

[73] *Ibid.,* 21-22 *per* James L.J.

from breaches of articles which give shareholders personal rights of action, or which can only be ratified by a special majority. As one might expect, the distinction is no more clear[74] than that between the ratifiable and non-ratifiable breaches of directors' authority, described in the previous section. However, in spite of the difficulties of definition, a distinction should be made between non-ratifiable breaches of the articles and mere irregularities for which a shareholder may not sue. Provisions for orders of compliance with the articles, such as sections 261 of the Ontario Act, may be of some help in this respect. The section does not give a shareholder a right to enforce the rules governing the company, but only to ask a court to do so. It is unlikely that every breach will be enjoined by the court, especially since a shareholder may complain of a breach of the by-laws as well as of the articles. A balance must therefore be struck between true grievances and technical breaches which really injure no one. The utility of section 261 is that it permits the courts to articulate such a broad rule without considering the hopelessly contradictory cases on a shareholder's right to enforce the company articles.[75]

NON-RATIFIABLE BREACHES

Of the exceptions to *Foss* v. *Harbottle*, the one most often argued when a director's breach of duty is in question is "fraud on the minority". That exception (apart from the special case of alteration of the company's articles) is usually said to encompass two fundamental duties: (1) not to expropriate corporate assets; and (2) to act *bona fide* in the best interests of the company.

1. Expropriation of corporate assets

Lord Davey found in 1902 that the expropriation of a company's assets was already a "familiar example"[76] of fraud on the minority.

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[74] *Pender* v. *Lushington, supra,* note 37 (shareholder wrongfully denied his right to vote); *Edwards* v. *Halliwell, supra,* note 52; *Peterson* v. *Cook* [1923] 1 W.W.R. 1212 (Sask. K.B.) (requirement that a matter be referred to a special majority of shareholders ignored by directors). See also, *supra,* note 65.

[75] It may be that shareholders who in the future complain of a breach of the articles may be forced to rely on s.261 of the Ontario Act if the courts, by analogy to their interpretation of s.99 in the *Farnham* decision, *supra,* note 15, hold that s.261 excludes the remedy at law. See also *Tycoos Developments Ltd* v. *Cookstown Estates Ltd* (1974) 2 O.R. (2d) 574, aff'd (1974) 3 O.R. (2d) 466 (C.A.) on the interpretation of s.16 of the Act. However, both ss.16 and 99 make significant procedural demands upon the plaintiff-shareholder. S.261 has no such requirements.

[76] *Burland* v. *Earle, supra,* note 29, 93.

In discussing the case "where the majority are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company",[77] he referred to *Menier* v. *Hooper's Telegraph Works*.[78] There the European and South American Telegraph Company had been formed to lay a transatlantic cable for which it sought a license from the Brazilian government. One of the company's directors obtained the license in his own name, and organized a second company to exploit it. An injunction sought by the European company against the personal use by the director of the license was refused on balance of convenience without a determination of who was its rightful owner. Plans were made to appeal the judgment when the defendant, as majority shareholder in the European company, had a resolution passed abandoning the appeal and winding up the company. For this service, the defendant received a large payment from a third company in league with the director's new company. Both Mellish and James L.JJ. held that the side payment amounted to a sale of corporate assets for the sole benefit of the defendant, Hooper's Telegraph Works. The minority shareholder who brought the action therefore had standing to complain of the defendant's conduct; if not "the majority might divide [among themselves] the whole assets of the company, and pass a resolution that everything must be given to them, and that the minority should have nothing to do with it".[79]

It will be noted that the defendant owed a duty not to expropriate company assets even though not a director. *Menier's* case is thus an interesting example of how, for some purposes, a majority shareholder may be a fiduciary of the company. But the case is among the most confusing in company law. In particular, how is it that the secret commission came to be an asset of the European company? It was never judicially determined that the company had any right to the license. The company's right was to the bribe paid to the defendant. However, since "that old *enfant terrible* of restitution",[80] *Lister & Co.* v. *Stubbs*,[81] such a right has usually been considered to be personal and not proprietary. In that case, the defendant was a general purchasing agent of the plaintiff manufacturing company. In the course of his purchases

[77] *Ibid.*

[78] *Supra*, note 3.

[79] *Ibid.*, 353 *per* James L.J.

[80] D.M.W. Waters, *The Constructive Trust* (1964), 283.

[81] (1890) 45 Ch.D. 1 (C.A.); see also *Metropolitan Bank* v. *Heiron* (1880) L.R. 5 Ex.D. 319 (C.A.).

from one company, Stubbs received large secret commissions for placing orders with it. His employer brought an action to recover the money, but before any judgment was reached the employer sought an injunction to prevent Stubbs from dealing with the real estate in which a portion of the bribes had been invested. The plaintiff's right to recover the bribes was never doubted, but the claim to follow the money failed. The relationship between the parties was one of debtor and creditor, and not of trustee and *cestui que trust*. While the money was owed to Lister & Co., the company did not yet own it in equity.

It has been suggested that the rule in *Lister & Co.* v. *Stubbs* can be narrowed to a question of procedure. A trust relationship may be created by a court, but until that time a *cestui que trust* has no proprietary interest in the asset. This was clearly the view of Rand J. in *McLeod* v. *Sweezey*:

> The holding [in *Lister & Co.* v. *Stubbs*] ... was strictly limited and it was to the effect that, until the right of the plaintiff to money of the sort in question had been established by a judgment, the court would not assist him in pursuing it into other forms of property.[82]

The plaintiff's mistake in *Lister & Co.* v. *Stubbs* was therefore to assert a proprietary right before it had been properly created by the court. If the judgment may be so restricted, the bribes in *Menier's* case may well be seen as corporate assets. However, most commentators agree that the principle in *Lister & Co.* v. *Stubbs* involves a substantial rule of equity.[83] If so, the bribes were not, *strictu sensu*, corporate assets. They belonged solely to Hooper's Telegraph Works, although it was under a personal obligation to give them to the European company.

One way around this difficulty is to say that corporate assets need not belong to the company under a constructive trust, since the right to trace in equity, and standing under *Foss* v. *Harbottle* are quite different matters with quite possibly different concepts of corporate assets. Something less than full proprietary rights under a trust may be sufficient to establish a fraud on the minority.

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[82] (1944) S.C.R. 111, 117. *Cf.* the discussion in D.M.W. Waters, *supra*, note 80, 336 on *Lister & Co.* v. *Stubbs;* and *H.E.P.C.* v. *Brown* (1959) 21 D.L.R. (2d) 551 (Ont. C.A.).

[83] R. J. Oerlon (ed.), *Underhill's Law Relating to Trusts and Trustees* 12th ed. (1970), argues that Stubbs was not a fiduciary, and suggests at 241 that it might be otherwise in cases of "an exceptionally fiduciary character". Directorships are apparently not of such a character; *ibid.*, 240. *Cf.* L.C.B. Gower, *supra*, note 54, 555, and R. Goff and G. Jones, *The Law of Restitution* (1966), 459-60.

But it is just this full equitable ownership which has been urged as the basis for a distinction between ratifiable and non-ratifiable uses of company property. Thus in *Cook* v. *Deeks*[84] Lord Buckmaster L.C., purporting to follow *Menier's* case, distinguished "the case of a director selling to his company property which was in equity as well as at law his own, and which he could dispose of as he thought fit" from that "of a director dealing with property which, though his own at law, in equity belonged to his company".[85] The defendants had negotiated a contract, ostensibly as company representatives, but in reality on their own behalf. This was held a breach of their fiduciary duties as directors; nor were they able, as majority shareholders, to ratify the breach. The benefit of the contract "belonged in equity to the company and ought to have been dealt with as an asset of the company".[86]

On the other hand, several members of the House of Lords suggested in *Regal (Hastings) Ltd* v. *Gulliver*[87] that directors' breaches in a similar situation might be ratified. There, it will be recalled, the directors of a company purchased shares in a second company when it appeared that the parent company was financially unable to organize it as a wholly-owned subsidiary. Notwithstanding the directors' good faith, they were held liable for profits made from the sale of the shares they had purchased, under the strict rule of *Keech* v. *Sandford*.[88] However, Lord Russell stated that "[t]hey could, had they wished, have protected themselves by a resolution (either antecedent or subsequent) of the Regal shareholders".[89]

Professor Gower would distinguish these cases along the lines of the "equitable property" doctrine.[90] In *Cook* v. *Deeks*, the directors were under a duty to acquire a contract for their company, and their personal appropriation of the benefit of the contract was an expropriation of assets which belonged in equity to the company

[84] [1916] 1 A.C. 554 (P.C.).

[85] *Ibid.*, 563.

[86] *Ibid.*, 564. "In *Cook* v. *Deeks* resolutions were in question which disclaimed on behalf of a company any interest in a contract made by persons who were directors of the company and who formed the majority of shareholders passing the resolutions. They were in fact constructive trustees of the benefit of the contract": *Peters' American Delicacy Co.* v. *Heath* (1939) 61 C.L.R. 457, 506 *per* Dixon J.

[87] [1942] 1 All E.R. 378.

[88] (1726) Sel.Cas.Ch. 61; 25 E.R. 223.

[89] *Supra*, note 75, 389; *cf.* 382 *per* Viscount Sankey and 394 *per* Lord Wright.

[90] L.C.B. Gower, *supra*, note 54, 565-66.

and therefore not ratifiable. But in *Regal*, the directors were under no duty to subscribe for the shares, which never belonged to the parent company. On the sale of the shares the directors made a mere "incidental profit",[91] for which they were liable to account, like Stubbs, to their company. The company could therefore have ratified the breach and allowed them to keep the profits. Under Professor Gower's theory, it would appear that most bribes paid to directors may be ratified.

One may hesitate before accepting a view which would allow directors to escape the consequences of their breaches in such a large class of corporate fraud. Happily, the "equitable property" test is hardly immune to criticism. It rests, first of all, on a substantive interpretation of *Lister & Co.* v. *Stubbs*[92] which has not passed without criticism in the Supreme Court of Canada.[93] Further, there is little authority, other than the dicta in *Regal*, to support it.[94] On the contrary, it would seem to have been rejected not only by the Court of Appeal in *Menier's* case, but possibly as well by the Supreme Court of Canada in *Zwicker* v. *Stanbury*.[95] In that case, the majority shareholders of a company on the verge of liquidation surrendered their shares to the company's directors, who also purchased second mortgage bonds from the shareholders at one-half their face value. The directors' interest in these transactions arose from their belief that they could persuade the company's first mortgage bondholders to accept a scheme of refinancing. The directors could not be said to have been under a duty to acquire the shares for their company since the company could not hold its own shares. Speaking for a majority of the Court, Kellock J. stated that the directors "both in their acquisition of the shares and the second mortgage were arrogating to themselves a secret profit",[96] and held that the plaintiff shareholder had standing to bring a derivative action against the directors under the rule in *Menier's* case. The actual basis of the decision is left somewhat in doubt by Kellock J.'s statement that "[t]hey did not obtain the consent of the shareholders and both transactions, therefore, for the reasons stated, cannot stand".[97] If, like Lord Wright, to whom he referred immediately above, Mr Justice Kellock would permit ratification, we

[91] *Ibid.*, 565.
[92] *Supra*, note 81.
[93] *Supra*, note 82.
[94] One such case is *Robinson* v. *Randfontein Estates* (1921) A.D. 168 (S.A.).
[95] [1953] 2 S.C.R. 438.
[96] *Ibid.*, 451.
[97] *Ibid.*

have here a true exception to *Foss* v. *Harbottle* — a case where shareholders may complain of a ratifiable breach. But the quoted sentence is not a paradigm of lucidity and it is suggested that the rule in *Foss* v. *Harbottle* is so well established that something more is required to overrule it.[98]

It may also be exceedingly difficult, as Gower recognizes,[99] to distinguish corporate assets from mere personal obligations owed to the company. Corporate assets include not only the company till, but also opportunities which a director has a duty to acquire for his company. Where secret profits are made by directors through the use of a corporate opportunity, they become trustees of the profit for the true corporate owner of the opportunity.[100] It is not necessary to prove in these cases that the opportunity would have fallen to the company had it not been diverted by the director.[101] But there are cases where it is clear that while the director might have profited from the opportunity, the company, for one reason or another, could not: the seller might not have been willing to deal with the company; [102] the company might not have been able to finance the transaction; [103] or the company might have been prevented from making use of the opportunity by legal restraints.[104] In such cases, it is difficult to speak of a "corporate" opportunity.

The concept of property has also been greatly stretched in an effort to do justice between the parties. For example, the management of a public company has a duty to make a market for its shares. But in what sense can it be said, as the Maryland Circuit

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98 It has been suggested, however, that such an exception may be found in *Hogg* v. *Cramphorn Ltd* [1967] Ch. 254 and *Bamford* v. *Bamford* [1970] Ch. 212 (C.A.). See L.C.B. Gower, *supra*, note 54, 585-86, and K. W. Wedderburn, Note (1967) 30 M.L.R. 77, 82-83 and *infra*, at 189-191.

99 L.C.B. Gower, *supra*, note 54, 554-56.

100 *Henry* v. *Hammond* [1913] 2 K.B. 515, 522.

101 *Canadian Aero Service Ltd* v. *O'Malley*, *supra*, note 3.

102 *Keech* v. *Sandford*, *supra*, note 88.

103 *Regal (Hastings) Ltd* v. *Gulliver*, *supra*, note 87.

104 *Cf. Zwicker* v. *Stanbury*, *supra*, note 95. Other difficulties may arise in parent-subsidiary situations: contrast *David J. Greene & Co.* v. *Dunhill International Inc.* 249 A.2d 429 (1969, Del.Ch.) and *Sinclair Oil Corp.* v. *Levien* 280 A.2d 717 (1971, Del.S.C.); or where a director owes a duty of loyalty to more than one company; contrast *Atkins and Durbrow Ltd* v. *Beil* (1957) 10 D.L.R. (2d) 484 (B.C. C.A.) and *In re Investors Management Co.*, Securities and Exchange Act Release 9267, 29 July 1971 with *Boulting* v. *Ass'n of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. 606 (C.A.) *per* Lord Denning M.R. and *Black* v. *Shearson, Hammill & Co.* 72 Cal.Rptr. 157 (1968, Calif. C.A.).

Court found in *United Funds, Inc.* v. *Carter Products, Inc.*, that a listing on the New York Stock Exchange is a valuable corporate asset? [105] The suggestion in *Boardman* v. *Phipps* [106] that confidential information may be property would further expand the definition of corporate assets, so far in fact that most of the secret profit cases would be subsumed under it.

Finally, at its broadest, corporate assets may include all claims a company has against its directors. If corporate opportunities which may never mature or secret information belong to the company in this sense, we are evidently not dealing with an accountant's concept of assets. Any liability of a director to his company as a result of a breach may therefore be a company asset, and any ratification of the breach an expropriation of such assets. If a director is found to owe $10,000 to the company under a section 99 action for breach of his duty of care and skill, is a subsequent ratification anything other than a mere present to him of that amount? [107]

The class of corporate assets may thus be almost as broad or as narrow as one wishes. At its most narrow, under the "equitable property" doctrine, many cases of fraud would seem ratifiable. At the other extreme, no breach of any sort may be ratified. Like Price's Exchequer Reports, it may be said of the doctrine that if one looks hard enough one may find whatever one wants.[108]

Moreover, the doctrine of corporate assets, however expressed, is arbitrary. A determination of whether a director may in fairness be allowed to retain a profit made in dealings with the company must depend upon more than a study of the definition of property in company or trust law. The doctrine should therefore be abandoned in favour of a rule more in keeping with contemporary ideas of commercial fairness.

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[105] C.C.H. Fed.Sec.L.Rep. 91,288 (1963); *cf. Jones* v. *H. F. Ahmanson & Co.* 1 Cal.2d 93, 460 P.2d 464 (1969, Calif.S.C.). Further, in what sense is "[t]he right to issue new capital ... an advantage which belongs to the company" so that an improper exercise of the power by the directors can be restrained in a derivative action under *Cook* v. *Deeks*? *See Ngurli Ltd* v. *McCann* (1953) 90 C.L.R. 425, 447-48 *per curiam* and *Martin* v. *Gibson* (1907) 15 O.L.R. 623.

[106] [1967] 2 A.C. 46.

[107] *Cf. Groel* v. *United Electric Co.* 61 A. 1061 (1905, N.J. Ch.); *Helvering* v. *Davis* 301 U.S. 619 (1937); *Keenan* v. *Eshleman* 194 A. 40 (1937, Del.Ch.); aff'd 2 A.2d 904 (1938, Del.S.C.); the dissent of Cohen J. in *Smith* v. *Brown-Borhek Co.* 200 A.2d 398 (1964, Pa.S.C.) and Comment (1936) 45 Yale L.J. 649, 665. One may of course argue that a director's liability in such a case is not a corporate asset because it may be ratified.

[108] Ashton, *As I Went on my Way* (1924), 27.

2. Lack of good faith

Where directors are given any powers in a company, "[t]hey must exercise their discretion bona fide in what they consider — not what a court may consider — is in the interests of the company, and not for any collateral purpose".[109] While examples of directors' fraud abound in the reports, it is sometimes difficult to distinguish the general duty of good faith from the expropriation of corporate assets. The distinction is perhaps best made in cases where an outside company or dissident shareholders attempt to take over a company. The directors and officers of the target company, whose future employment with that company may well depend on their retention of control, will be strongly tempted to adopt defensive tactics, the most common being a new issue of shares to the directors or their allies.[110] In most of these "proper purposes" cases, company rights were enforced by dissenting shareholders in derivative actions.[111] It would therefore seem that such breaches may not be ratified.

This exception to the possibility of ratification is, however, very much a child of *la doctrine*. Thus Professor Wedderburn asserts that "[t]here can be no doubt that acts which are *mala fide*, in the sense that the directors have primarily consulted interests other than those of the company, are open to challenge by the minority on grounds of 'fraud' ".[112] But many of the cases cited in support of the rule are less than wholly persuasive. Some, for example, also involve an expropriation of corporate assets.[113] Others allowing

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[109] *In Re Smith & Fawcett Ltd* [1942] Ch. 304, 306 *per* Lord Greene M.R. (C.A.). On the definition of "bona fide in the interests of the company", see *Greenhalgh* v. *Arderne Cinemas Ltd* [1951] Ch. 286 (C.A.).

[110] *Cf.* cases cited *infra*, note 102. For a good discussion of this and other manoeuvres, see E. C. Schmults and E. J. Kelly, *Cash Take-over Bids — Defense Tactics* (1967) 23 Bus. Law. 115. See also *Cannon* v. *Trash* (1875) L.R. 20 Eq. 669 (setting the date of a general meeting at such a time as to prevent some shareholders from voting); *Legion Oils Ltd* v. *Barron* (1956) 2 D.L.R. (2d) 505 (Alta S.C.) (increasing the number of directors to retain control of the board); *Galloway* v. *Halle Concerts Society* [1915] 2 Ch. 233 (making calls against only a few dissident shareholders when the vast majority of shareholders have not fully paid for their shares).

[111] *Cannon* v. *Trask, ibid.*, and *Galloway* v. *Halle Concerts Society, ibid.*, and cases cited *infra*, note 113.

[112] K. W. Wedderburn, *supra*, note 2, 98; see also Note, *supra*, note 85, 81 and L.C.B. Gower, *supra*, note 54, 566-67. But *cf.* B. H. McPherson, *Limits of Fraud on the Minority* (1960) 77 S.A.L.J. 297, and R. W. Parsons, *The Director's Duty of Good Faith* (1967) 5 Melb.U.L.R. 395, 423.

[113] *Atwool* v. *Merriweather* (1867) 5 Eq. 464, n; *Menier* v. *Hooper's Telegraph Works, supra*, note 3; *Mason* v. *Harris* (1879) 11 Ch.D. 97 (C.A.); *Alexander* v.

derivative actions deal with the issuance of new shares to maintain control of a company. That such a breach might be ratified by a majority resolution was never made wholly clear until recently,[114] but derivative actions to prevent the directors from usurping control were always permitted. Since shareholders have derivative actions for ratifiable breaches, these are true exceptions to the rule in *Foss v. Harbottle*. In these cases, the directors appeared quite willing to use their new voting strength to prevail over their opponents and even, perhaps, to ratify the breach.[115] A derivative action was therefore necessary to ensure that the principle of majority rule in *Foss* v. *Harbottle* would be preserved. Without such a remedy, "the shareholders holding the smaller amount of shares [might] control the holders of a very considerable majority".[116] Such cases are unique since the breach may determine the result of the vote of ratification. It is therefore somewhat uncertain whether or not other *male fide* breaches may be ratified.

If a general rule that *mala fide* breaches may not be ratified is not to be found in the authorities, one may nevertheless feel that such a rule should exist. It seems particularly iniquitous to allow a director to escape liability where he has been found to be in bad faith. Such a rule would seem especially suitable in Canada,

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Automatic Telephone Co. [1900] 2 Ch. 56 (C.A.); *Cook* v. *Deeks, supra,* note 62; *Trustee of the Property of C.E. Plain Ltd* v. *Kenley* [1931] O.R. 75 (App.Div.); *Millers (Invercargill) Ltd* v. *Maddams* [1938] N.Z.L.R. 490 (C.A.); and *Re W. & M. Roith Ltd* [1967] 1 W.L.R. 432. The clearest statement of the rule is perhaps in *Ngurli Ltd* v. *McCann, supra,* note 105. There too, however, it was thought necessary to rely on the "equitable property" doctrine of *Cook* v. *Deeks, ibid.,* 447-48.

114 See *Hogg* v. *Cramphorn* and *Bamford* v. *Bamford, supra,* note 98.

115 *Fraser* v. *Whalley* (1864) 2 H. & M. 10; 71 E.R. 361; *Punt* v. *Symons & Co.* [1903] 2 Ch. 506; *Piercy* v. *S. Mills & Co.* [1920] 1 Ch. 77; *Madden* v. *Dimond* (1906) 12 B.C.R. 80; *Glace Bay Printing Co.* v. *Harrington* (1910) 45 N.S.R. 268; *Bonisteel* v. *Collis Leather Co.* (1919) 45 O.L.R. 195; *Smith* v. *Hanson Tire & Supply Co.* [1927] 3 D.L.R. 786 (Sask.C.A.); *Spooner* v. *Spooner Oils Ltd* [1936] 2 D.L.R. 634 (Alta S.C. A.D.); *Caufield* v. *Sunland Biscuit Co.* [1941] 4 D.L.R. 714 (Alta S.C.); *Hogg* v. *Cramphorn Ltd, supra,* note 98. In the last two cases, the directors proposed to vote the new shares in ratification of the breach. Where the minority shareholders have enough shares to prevent the majority from enacting fundamental changes, and shares are issued to give the controlling shareholders the necessary super-majority, the minority shareholders may require that the new offer be prorated even in the absence of express pre-emption rights in the articles. Ratification of the breach by a majority is not allowed; *Martin* v. *Gibson, supra,* note 105.

116 *Punt* v. *Symons & Co., ibid.,* 515 *per* Byrne J.

whose courts do not appear to follow the objective English test of the proper purposes doctrine.[117]

TWO ANOMALOUS CASES

1. Directors' remuneration

Directors and officers may be rewarded in any number of ways: they may be paid a salary as ordinary company employees; they may receive long term low-interest loans; [118] they may be offered lucrative stock options; they may participate in a profit-sharing plan; or they may be provided with a pension or similar retirement benefits. But directors have no right to any remuneration unless authorized by a statute or the articles of the company,[119] nor in general can they argue that they are entitled to be paid on a *quantum meruit* basis.[120]

Since directors are frequently officers of their company, the compensation of officers usually also involves a conflict of interests. The possibilities of overreaching are therefore such that some form of judicial review of executive rewards is essential. But how are substantive criteria of fairness to be formulated? Comparisons are not always odious at law, but they are of little worth here if a standard of reasonable compensation cannot be found:

> If comparisons are to be made, with whose compensation are they to be made — executives? Those connected with the motion picture industry... Justices of the Supreme Court of the United States? The President of the United States?[121]

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[117] For the English test, see *Hogg* v. *Cramphorn Ltd, supra,* note 98 and *Bamford* v. *Bamford, supra,* note 98. These cases were distinguished by the British Columbia Supreme Court in *Teck Corp.* v. *Millar* (1972) 33 D.L.R.(3d) 288. *Cf.* also *Northern & Central Gas Corp.* v. *Hillcrest Collieries Ltd* (1975) 59 D.L.R.(3d) 533, 598-99 (Alta S.C.).

[118] Now substantially regulated by the *Business Corporations Act, supra,* note 4, ss.17, 146 and 178.

[119] *In Re George Newman & Co.* [1895] 1 Ch. 674, 686 *per* Lindley L.J. See also *Northern Trust Co.* v. *Butchart* (1917) 35 D.L.R. 169 (Man. K.B.).

[120] *Hutton* v. *West Cork Ry. Co., supra,* note 60; *Cook* v. *Hinds* (1918) 42 O.L.R. 273, 304-305 *per* Rose J. (App.Div.); and *D'Amore* v. *McDonald* (1973) 33 D.L.R. (3d) 543, 561 *per* Addy J. (Ont. H.C.), aff'd [1974] 1 O.R.(2d) 370 (C.A.). F. W. Wegenast, however, argued that where the director has served the company in another capacity, for example, as a manager, he may recover on a *quantum meruit*; *supra,* note 66, 420. *Cf. Brown* v. *Gentleman* [1971] S.C.R. 501, 517 *per* Spence J.

[121] *Heller* v. *Boylan* 29 N.Y.S.2d 653, 679 (1941) *per* Collins J.; aff'd 32 N.Y.S. 2d 131. But *cf. Beard* v. *Elster* 39 Del. Ch. 153, 160 A.2d 731 (1960); on remand

The difficulty in establishing an objective standard of compensation is that typically no market exists to mimic.[122] Compensation schemes vary so greatly that a consideration of other remuneration plans will be useful in only the most extreme cases. Further, if some *quid pro quo* is relevant, how can one measure the benefit a company receives from a loyal staff of competent managers? A final problem is created by differing concepts of the corporation. If it is seen as a group of capitalists hiring managers, then it follows that the managers should merely receive wages, with any large profits accruing to the shareholder-capitalist. But if it is really the entrepreneurs who hire capital, why should they not participate in large gains in profits?[123] As a result of such difficulties, courts frequently find themselves "ill-equipped to solve or even to grapple with these entangled economic problems".[124]

In the absence of a clear substantive criterion of fairness, the legislators and courts have developed procedural requirements for directors' fees. Thus the *Business Corporations Act* provides that a director's remuneration must be authorized by a by-law passed by the board. The by-law must in turn be submitted at a general meeting to the shareholders, who may confirm, reject or amend it.[125] However, in those exceptional cases where a payment can be shown to be unreasonable, it may be *ultra vires* the company or a fraud on the minority.

39 Del.Ch. 476, 167 A.2d 231 (stock option plan); and *Saxe* v. *Brady* 40 Del.Ch. 474, 184 A.2d 602 (1962) (management contract with mutual fund).

[122] Even the economists have failed to provide a scientific model of reasonable compensation. See J. C. Baker, *A 'Just Gauge' for Executive Compensation* (1943) 22 Harv.Bus.Rev. 75; R. B. Mautz and G. W. Rock, *The Wages of Management* (1958) 11 U.Fla.L.Rev. 474; and A. Patton, *What is an Executive Worth?* (1961) 39 Harv.Bus.Rev. (2d issue) 65. See generally G. T. Washington and V. H. Rothschild, *Compensating the Corporate Executive* 3d ed. (1962).

[123] See A. A. Berle and G. C. Means, *supra*, note 31, 342-44. As a further problem, consider the "right" of workers to participate in the profits of a company. If it can be shown that the efforts of the President of General Motors have contributed 10,000 times more to the increased prosperity of the company than those of an ordinary machinist, should their salaries reflect this difference? See W. L. Cary, *Cases and Materials on Corporations* 4th ed. (1969), 612-13.

[124] *Heller* v. *Boylan*, *supra*, note 121, 680 *per* Collins J.

[125] *Supra*, note 4, s.21. On the right to remuneration without complying with the analogous requirements of the *Corporations Act*, R.S.O. 1970, c.89, ss.69 and 70, see *D'Amore* v. *McDonald*, *supra*, note 120, and F. W. Wegenast, *supra*, note 66, 401.

It is beyond the powers of a company to make presents to the directors which are not related to the affairs of the company.[126] The fee must be "within the ordinary scope of the company's business" or "reasonably incidental" to it.[127] Thus a pension to the widow of the managing director of a company negotiated *after* his death was held *ultra vires;*[128] so too was a widow's pension made before a director's death, where his health was not good, his loyalty was already guaranteed by his ownership of company stock and the agreement gave every appearance of being a mere sham.[129] Payments made after the company has effectively ceased to operate have also been held to be beyond the company's powers.[130] "The law does not say that there are to be no cakes and ale but that there are to be no cakes and ale except such as are required for the benefit of the company." [131]

Excessive salaries and gratuities to directors would seem as well to be obvious examples of the expropriation of corporate assets. Where the fee amounts to a mere gratuity, ratification is clearly impossible.[132] But it is otherwise where the company receives a reasonable benefit from the transaction:

> The company is in such a case obtaining the services for which it is paying, thus getting a quid pro quo, and there is, I think no foundation for the suggestion that in such a case there is an appropriation of property.[133]

There are few cases where, some services having been provided, such consideration has been found inadequate. One such case was *Brown* v. *Can-Erin Mines Ltd,* where a management contract awarded the majority shareholders of a company $60,000 a year "for carrying out services which a geologist and an accounting

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[126] *In Re George Newman & Co., supra,* note 119. This prohibition is not affected by the general grant of power in the *Business Corporations Act, supra,* note 4, s.15(2): *ibid.,* 686. It may be, however, that shareholder actions in such cases must comply with the provisions of s.16; see *supra,* note 75.

[127] *Henderson* v. *Bank of Australasia* (1888) 40 Ch.D. 170, 180 *per* North J.; adopted in *McAlpine* v. *Fleming* (1910) 15 O.W.R. 479, 492 *per* Latchford J. *Cf. Hutton* v. *West Cork Ry. Co., supra,* note 60, 671 *per* Bowen L.J.

[128] *In Re Lee, Behrens & Co.* [1932] 2 Ch. 46, 52-3 *per* Eve J.

[129] *Re W. & M. Roith Ltd, supra,* note 113.

[130] *Hutton* v. *West Cork Ry. Co., supra,* note 60, 677; *Cook* v. *Hinds, supra,* note 120, 307 *et seq., per* Rose J.

[131] *Hutton* v. *West Cork Ry. Co., ibid.,* 673 *per* Bowen L.J.

[132] *Lumbers* v. *Fretz* [1928] 4 D.L.R. 269 (Ont. S.C.); *D'Amore* v. *McDonald, supra,* note 120.

[133] *Foster* v. *Foster* [1916] 1 Ch. 532, 549 *per* Peterson J.

staff could carry out... for a small fraction of that amount".[134] However, a more typical example of fraud on the minority occurs where the remuneration is grossly inflated and the services are almost nonexistent.[135] It has been said that no mere hardship to the shareholders will suffice.[136] The transaction must itself be improvident or oppressive, although the court may consider the financial position of the company as well as the director's services.[137] Anything that resembles a *bona fide* agreement is likely ratifiable.[138] The onus of proof that the company has received an adequate benefit from their services is on the directors.[139] They may also have to prove that the transaction was *bona fide*,[140] although it is not quite clear what good faith means in this context.[141] It is difficult to see how an agreement supported by adequate consideration can be said to be *male fide*. Bad faith may, however, indicate that the agreement is a sham, and that the necessary *quid pro quo* was therefore lacking.[142]

Substantive limitations on executive remuneration, based upon the *ultra vires* rule or upon fraud on the minority, are therefore quite lax. Because of the great difficulty in articulating a rule of

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[134] (1960) 25 D.L.R.(2d) 250, 255-56 *per* Spence J. (Ont. H.C.).

[135] *Cook* v. *Hinds, supra,* note 120; *Barry* v. *Laroque* (1934) 72 C.S. 70; *Nolan* v. *Parsons* [1942] 3 D.L.R. 190 (Ont. C.A.).

[136] *Houston* v. *Victoria Machinery Depot Ltd* [1924] 2 D.L.R. 657, 659 *per* Murphy J. (B.C. S.C.).

[137] Compare *Houston* v. *Victoria Machinery Depot Ltd, ibid.,* and *Cook* v. *Hinds, supra,* note 120.

[138] *Hampson* v. *Price's Patent Candle Co.* (1876) 24 W.R. 754; *Parker and Cooper, Ltd* v. *Reading* [1926] 1 Ch. 975; *Allish* v. *Allied Engineering of B.C. Ltd* (1957) 9 D.L.R.(2d) 689 (B.C. C.A.).

One of the thorniest questions in this area of the law is whether directors may be remunerated for past consideration. Compare *Hutton* v. *West Cork Ry. Co., supra,* note 60 *per* Bowen and Baggallay L.JJ. and *Bartram* v. *Birtwhistle* (1908) 15 O.L.R. 634 with *Fuller* v. *Bruce* [1935] 3 D.L.R. 256 (N.S. S.C.). *Re Dorenwends Ltd* [1924] 3 D.L.R. 118 (Ont. S.C. A.D.) allowed a payment for past services which had been ratified by all the shareholders. However, it was suggested that ratification by a mere majority would not suffice: *ibid.,* 120 *per* Orde J.A. In light of these decisions, directors are best advised to draft their compensation schemes as contingent on future services.

[139] *Parke* v. *Daily News Ltd* [1961] 1 W.L.R. 493; *sed qu. Houston* v. *Victoria Machinery Depot Ltd, supra,* note 136.

[140] *In Re Lee, Behrens & Co., supra,* note 128, 51 *per* Eve J.; fll'd in *Parke* v. *Daily News Ltd, ibid.*

[141] See the comments of Bowen L.J. in *Hutton* v. *West Cork Ry. Co., supra,* note 60.

[142] *Re W. & M. Roith Ltd, supra,* note 113; *Millers (Invercargill) Ltd* v. *Maddams, supra,* note 113.

fairness on this question, one must expect that substantive barriers will remain weak. There would seem to be little that a legislator can do to curb overreaching directors in the absence of an economic model of what constitutes reasonable compensation for their services. Perhaps the best deterrent in all but extreme cases is the market for corporate acquisitions.

2. Contracts with the company

Any contract between a director and his company is voidable at the instance of the company under the general equitable principle of *Keech* v. *Sandford.*[143] "So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into." [144] This strict rule of equity is another example of a judicial reluctance to confront squarely questions of fairness. "It obviously is, or may be, impossible to demonstrate how far in any particular case the terms of such a contract have been the best for the cestui que trust." [145] Nevertheless, Ontario courts may in future be required to consider the fairness of such contracts under section 134 of the *Business Corporations Act.* The section provides that directors who have acted honestly and in good faith are not liable for profits made in contracts with their company if material conflicts of interests are disclosed and the contracts are ratified by disinterested directors or a two-thirds vote of shareholders.[146] But in either case it must be shown that the contract was in the best interests of the corporation at the time it was entered into.[147]

It may, however, be possible for a director to retain all profits through shareholder ratification without complying with the requirements of section 134. The authors of the *Proposals for a New*

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[143] *Supra,* note 88.

[144] *Aberdeen Rail. Co.* v. *Blaikie Brothers* [1843-60] All E.R. Rep. 249, 252 *per* Lord Cranworth L.C. The contract is also invalid if the director's interest is merely indirect, as where his company deals with a firm of which he is a partner: *ibid.;* or a company of which he is a director or a shareholder: *Transvaal Lands Co.* v. *New Belgium (Transvaal) Land and Development Co.* [1914] 2 Ch. 488 (C.A.). But *cf. Kaye* v. *Croydon Tramways Co.* [1898] 1 Ch. 358 (C.A.); in somewhat similar circumstances, the United States Second Circuit Court of Appeal came to an opposite conclusion: *Rosenfeld* v. *Black* 445 F.2d 1337 (1971).

[145] *Aberdeen Rail. Co.* v. *Blaikie Brothers, ibid.,* 252 *per* Lord Cranworth L.C.

[146] *Supra,* note 4, as am. by S.O. 1972, c.138, s.36.

[147] S.115(7) of the *Canada Business Corporations Act, supra,* note 5 requires instead that the contract be "reasonable and fair to the corporation at the time it was approved".

Business Corporations Law for Canada were confident that in the absence of statutory disclosure or ratification by a special majority, the director "has no immunity from the harsh common law rules which render the contract void".[148] But the rule at law was that such contracts were not void but voidable and capable of ratification by a simple majority.[149] It seems unlikely that the statutory rules have changed this, except insofar as they require ratification by two-thirds of the votes of the shareholders; this is quite obviously an example of the special majority exception to *Foss* v. *Harbottle*. But there is little to suggest that special fiduciary duties attach because of this, or that a director may not vote as a self-interested shareholder to ratify a contract which is not in the best interests of his company. Such contracts may then be ratified by a special majority unless it can be shown that they constitute an expropriation of corporate assets or, perhaps, that they are in bad faith. An explicit statutory prohibition of ratification except under section 134 is therefore necessary to prevent an avoidance of its requirements.

RATIFICATION AND SECTION 99

The above discussion suggests that directors may in too many cases escape liability through the rule in *Foss* v. *Harbottle*. How is this changed by section 99 of the *Business Corporations Act?*[150] The section does not, of course, affect personal actions by the shareholders, but only derivative actions under the last two exceptions to the rule. It may not even affect those, except to make proceedings more cumbersome and expensive if the courts adhere to the futility principle of *Foss* v. *Harbottle*. Assuming that ratification is still possible, some judges may be inclined to agree with Mullock J. that "it would be purposeless for the Court to entertain an action" where ratification is possible and the directors "might in substance repeat their former action".[151] But it was surely not the intent of the legislators to make it more *difficult* to bring derivative actions. Moreover, a subsequent ratification does little

[148] R.W.V. Dickerson, *Proposals for a New Business Corporations Law for Canada* (1971), vol.1, 80, s.233 (hereinafter called *The Dickerson Report*).

[149] *North-West Transportation Co.* v. *Beatty, supra*, note 39. See also *Hely-Hutchinson* v. *Brayhead Ltd* [1968] 1 Q.B. 549 (C.A.), a case of some interest since *The Dickerson Report* took s.199 of the *Companies Act, 1948*, 11-12 Geo.VI, c.38 "as a point of departure" in drafting para.9.17: *ibid.*, 79.

[150] *Supra*, note 4.

[151] *Kelly* v. *Electrical Construction Co.* (1907) 16 O.L.R. 232, 234.

injury to the dignity of the court. The basis of the futility principle is essentially economic. The costs of litigation for both courts and companies are such that derivative actions should be refused if it can be shown that breaches are invariably ratified. Against this must be weighed any external benefits derived from the sharpening of issues by the court and the possibility that the breach will not be ratified. While the bulk of the evidence indicates that directors may easily obtain the ratification of their breaches,[152] it is not so clear that they will always want to flex their corporate muscles in this way. The directors may decide for sound business reasons not to ratify, for example, where a takeover bid seems in the offing. Publicizing directors' breaches is highly impolitic where shareholder loyalty is important. It is therefore not clear that derivative actions should always be refused because a breach may be ratified, although the empirical evidence in favour of the futility principle would in most cases seem compelling.[153]

It may perhaps be argued that by permitting derivative actions in section 99, the legislature has implicitly forbidden ratification. Such an interpretation does not, however, appear to be warranted by the language of the section. Thus section 235 of the *Canada Business Corporations Act* explicitly provides that shareholder ratification shall not be a bar to a derivative suit under the Act. A similar amendment to section 99 would seem essential if the interests of minority shareholders in Ontario companies are to be adequately protected.

Such an amendment would still leave open the question of when a derivative action may be brought. A great deal of discretion will then be placed on judges who hear such actions. They will first be required to determine whether, in spite of clear evidence of a breach, the suit should be refused for business reasons.[154] This may frequently be beyond the competence of a judge, who may have to rely on a strict, prophylactic rule, without reference

[152] See *supra*, note 31.

[153] If directors' breaches may still be ratified, courts should also be hesitant to order a ratification by shareholders. In most cases, this will be a meaningless and expensive gesture. Moreover, in those few cases where the directors may prefer not to ratify, the shareholders will be better off without such an order. The court may also find itself intruding rather clumsily in a takeover attempt.

[154] See R.N. Leavell, *supra*, note 14. The judges' discretion is emphasized by the prohibition of security for expenses in s.99(3); *cf. Kaufman* v. *Wolfson* 136 F.Supp. 939 (1955, S.D. N.Y.). But *cf.* also D. J. Dykstra, *The Revival of the Derivative Suit* (1967) 116 U.Pa.L.Rev. 74, 93.

to what is fair. However, insofar as it is possible, he should attempt to evolve criteria of fairness.

One touchstone which as been suggested is ratification itself. In the United States, where derivative actions may be brought under similar legislative rules, shareholder ratification has been held to constitute evidence of fairness.[155] The authors of *The Dickerson Report* would also have the courts look to ratification:

> If, for example, the alleged misconduct was ratified by majority shareholders who were also the directors whose conduct is attacked, evidence of shareholder ratification would carry little or no weight. If, however, the alleged misconduct was ratified by a majority of disinterested shareholders after full disclosure of the facts, that evidence would carry much more weight... .[156]

While the repeal of the rule in *North-West Transportation Co.* v. *Beatty*[157] is long overdue, any reliance upon "disinterested shareholders after full disclosure of the facts" would generally be misplaced. "The incompetency of the shareholder of a widely-held corporation, even if he takes an active interest, to deal with the problem of proposed action against directors is beyond debate."[158] By contrast, a judge considering a breach will usually be in a far better position to examine the unfairness of directors' acts. The decision of a disinterested board of directors may, however, be of some weight in the threshold problem of whether to compromise or abandon the claim because of possible injury to the good name of the company.

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[155] *Alcott* v. *Hyman* 208 A.2d 501 (1965, Del.S.C.). Comparisons between United States and Canadian rules on ratification are difficult. Firstly, some American courts make a distinction between ratification and a decision by shareholders not to sue: *S. Solomont & Sons Trust* v. *New England Theatre Operating Corp., supra,* note 14, discussed in a Note (1950) 64 Harv.L.Rev. 334. It is also unclear to what extent American decisions follow the rule in *North-West Transportation Co.* v. *Beatty, supra,* note 39. Several cases have held that an interested director may vote as a shareholder to ratify a contract which appears fair: *Gamble* v. *Queens County Water Co.* 123 N.Y. 91; 25 N.E. 201 (1890); *Bjorngaard* v. *Goodhue County Bank* 49 Minn. 483; 52 N.W. 48 (1892). However, most cases involving a director's fraud which permit ratification insist on a vote of disinterested shareholders; *e.g., Claman* v. *Robertson, supra,* note 14. According to W.L. Cary, *supra,* note 123, 592 even a ratification by disinterested shareholders will not validate a fraud in most jurisdictions. *Cf. Mayer* v. *Adams* 141 A.2d 458 (1958, Del.S.C.) and *Continental Securities Co.* v. *Belmont* 99 N.E. 138 (1912, N.Y. C.A.). *Cf.* generally R. N. Leavell, *supra,* note 14; Note (1940) 53 Harv.L.Rev. 1368; A. T. Stickells, *Derivative Suits — The Requirement of Demand upon the Stockholders* (1953) 33 B.U.L.Rev. 435; and Landstrom, *Ratification by Majority Stockholders — A Problem in Corporate Democracy* (1951) 31 B.U.L.Rev. 165.

[156] *Supra,* note 148, 164, s.487.

[157] *Supra,* note 39.

[158] R. N. Leavell, *supra,* note 14, 355.

It may be useful to distinguish the nature of the breaches. Thus one may wish to allow directors to ratify acts of negligence, where, unlike most cases of fraud, they do not personally profit.[159] An analogous situation arises where directors make a profit without causing a loss to the company. In such cases, of which *Regal (Hastings) Ltd* v. *Gulliver*[160] is a prominent example, it may not be unfair to allow the director to retain the profit.[161]

The *Regal* decision provides an example of another difficulty in evolving criteria of fairness. Derivative actions are brought on behalf of a company and, if damages are awarded, they are paid to it and not to the shareholders. However, the shareholders will normally receive an indirect benefit, and one who purchases shares after the breach may receive a windfall from the action,[162] while the prior owner is left without a remedy. This problem is particularly obvious where, as in *Regal*, new shareholders control the company and can in effect expropriate the benefit of the judgment.

Another possible consideration is the nature of the corporation. I have already suggested that ratification by shareholders in a close corporation is better evidence of fairness than ratification in a public company. But here too the question of fairness may at times be better left to a judge. In a small corporation the possibilities of backscratching are such that even the vote of a "disinterested" majority in ratification may be suspect. While presumably better-informed than his counterpart in A.T. & T., a shareholder in a private company may be less concerned with fairness than with freezing out another member. In addition, members of a close corporation who decide that its directors are rogues or fools may not be able to sell their shares. Shareholders in a widely-held corporation who despair of fair treatment may at least sell out, even if at a lower price than they might wish.

The criteria of fairness for examining a director's acts are extremely vague. So, however, are any provisions which attempt

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159 *Cf. Smith* v. *Brown-Borhek Co., supra,* note 107.

160 *Supra,* note 87.

161 *Cf. Canadian Aero Service Ltd* v. *O'Malley, supra,* note 3, 608 *per* Laskin J.

162 Although he may not bring a derivative action himself under the Ontario *Business Corporations Act, supra,* note 4, because of the contemporaneous ownership provision in s.99(3)(a). However, if he is in control of the company, he may have the action brought by it as the new shareholders did in *Regal (Hastings) Ltd* v. *Gulliver, supra,* note 87. American courts are more willing to look through the corporate veil in these cases, at least where no shareholder may bring a derivative action: *Home Fire Insurance Co.* v. *Barber* 93 N.W. 1024 (1903, Neb.S.C.); *Capitol Wine & Spirit Corp.* v. *Pokrass* 98 N.Y.S.2d 291 (1950); aff'd 302 N.Y. 734.

to do equity between the parties whenever possible. In the tension between prophylactic rules and the broader claims of fairness, an argument often raised in favour of rigid principles is that the matter is so complicated that it is impossible for a court to determine the guilt or innocence of directors. The amount of a director's salary is frequently of such a character.[163] In most cases, however, questions of fairness are not institutionally insoluble, but merely difficult. On the other hand, prophylactic rules are, if not always fair, at least superficially inexpensive. They avoid the high transaction costs of lengthy trials. But in the end they may involve higher costs to society than rules of fairness. A shareholder hopes to be treated fairly by the management of his company; he does not expect windfalls of the sort received in *Regal (Hastings) Ltd* v. *Gulliver*.[164] Moreover, strict rules may discourage managers from investing money and labour in their company. General criteria

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[163] See *supra*, "Directors' remuneration" at 191.

[164] *Supra*, note 87. I am assuming the continuing demand for outside capital and the consequent need for managers to interest investors in their companies: *cf*. J. Lintner, "The Financing of Corporations" in E. S. Mason (ed.), *supra*, note 32, 166. H. G. Manne has argued that Lintner's findings demonstrate that "there can probably be no substantial danger to the shareholders of large corporations"; *The "Higher Criticism" of the Modern Corporation, supra*, note 32, 402. However, takeovers usually involve high transaction costs: the controlling shareholders may require a premium for their shares if they decide to accept the offer; if not, the offerees may have to comply with the onerous provisions for disclosure and proration in *The Securities Act*, R.S.O. 1970, c.426, ss.81-100. Some further protection to shareholders would therefore seem necessary. Thus, even before the Williams Bill, 15 U.S.C. ss.78m(d)-(f), Manne himself recognized the need for derivative actions: *Our Two Corporation Systems: Law and Economics* (1967) 53 Va. L.Rev. 259, 272.

A second problem arises from lingering doubts about the competence of judges to decide difficult questions of fairness and loyalty of directors. One response to this has been vague suggestions of a "second chamber" to sit in judgment over the directors: B. Manning, Book Review, *supra*, note 32 and E. V. Rostow, "To Whom and for what Ends is Corporate Management Responsible?" in E. S. Mason (ed.), *supra*, note 32, 46. It is not clear, however, how such a body could be more independent of the managers of a modern corporation than its directors. If it cannot, there would seem little reason for its creation. It has therefore been suggested that independent administrative boards might supplement or replace the courts in some matters. In England, for example, the Board of Trade has been given broad powers to investigate a company's affairs: R. D. Fraser, *Administrative Powers of Investigation into Companies* (1971) 34 M.L.R. 260. But the federal courts in the United States have recently asserted a broad competence over corporate affairs under the rapidly expanding definition of "fraud" in S.E.C. Rule 10b5. While the ambit of the rule has given rise to much discussion, the commentators have not suggested that the courts should be replaced by administrative tribunals.

of fairness may therefore be economically more efficient than prophylactic rules.[165]

The decision of the Supreme Court in *Canadian Aero Service Ltd* v. *O'Malley* suggests that Canadian courts will now be more willing to consider "general standards" of "loyalty" and "good faith"[166] to the exclusion of "rigid measure[s]" and "literal terms".[167] Chief Justice Laskin rejected the strict tests of liability of *Regal (Hastings) Ltd* v. *Gulliver*, noting that "I need not pause to consider whether on the facts in [that case] the equitable principle was overzealously applied".[168] Similar doubt was cast[169] on the previous Supreme Court decision in *Peso Silver Mines Ltd* v. *Cropper*.[170] However, one would miss the subtlety of Laskin C.J.'s reasoning if one thought that these cases were overruled. The difference between *Canadian Aero Service Ltd* v. *O'Malley* and the cases which preceded it is attitudinal. "[T]he particular facts" in a case of corporate fraud "may determine the shape of the principle of decision without setting fixed limits to it."[171] Future decisions must therefore be considered on their merits, without the "strait jacket"[172] of narrow rules. One may consequently expect that the judicial leitmotif, whether articulated or not, will be increasingly one of fairness.

Fairness need not, of course, imply laxity. If liability is no longer to be determined by considering the rigid rules of *Peso* or *Regal*, one must still have regard to "the pervasiveness of a strict ethic in this area of the law".[173] The novelty of Chief Justice Laskin's

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165 All, however, depends on the context. It may be that a prophylactic rule is of use in providing a collateral social good. Thus strict rules against insider trading may stimulate the disclosure of corporate information to the public; see *Shapiro* v. *Merrill, Lynch, Pierce, Fenner & Smith Inc.* 495 F.2d 228 (1974, 2d C.C.A.). But *cf.* H. G. Manne, *Insider Trading in the Stock Market* (1966). See also H.-K. Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934* (1968) 68 Colum.L.Rev. 260.

166 *Supra*, note 3, 610.

167 *Ibid.*, 609. See also *Goldex Mines Ltd* v. *Revill*, *supra*, note 17, 224: "Fairness is the touchstone of equitable justice, and when the test of fairness is not met, the equitable jurisdiction of the Court can be invoked to prevent or remedy the injustice which misrepresentation or other dishonesty has caused. The category of cases in which fiduciary duties and obligations arise is not a closed one...".

168 *Ibid.*, 608.

169 *Ibid.*, 618-19.

170 [1966] S.C.R. 673.

171 *Supra*, note 3, 619.

172 *Ibid.*, 619.

173 *Ibid.*, 607.

approach in *Canadian Aero Service Ltd* v. *O'Malley* is methodological and not ethical. The new duty may, in particular cases, prove more exacting than the old rules.[174]

CONCLUSION

The rule in *Foss* v. *Harbottle* was based in large part on the entirely pragmatic concern that derivative actions might be pointless if director's breaches were ratifiable. That concern is as valid today as it was in 1843. The rule therefore neatly divided all breaches into those which were ratifiable and those upon which derivative actions would lie. Unfortunately, undue reliance was placed on the capacity of a majority of shareholders to solve internal management problems, and most breaches were classified as ratifiable. The derivative action was then limited to the most extreme cases of oppression. The unfairness of the division was only noted when studies of the modern corporation revealed the weakness of the shareholders and the power of management. Company law reform must seek to redress this imbalance in some effective manner.

The goal of all norms of company law should be to persuade shareholders of the security of their investments. Some risks are of course intrinsic to any investment. However, the separation of ownership and control has created a second level of uncertainty.[175] Shareholders must not only take the risk, necessarily incidental to every investment, that the market will not react favourably to their company; they now take the additional gamble that the company's managers may be dishonest or incompetent. It is unlikely that this second risk can be eliminated through "shareholder democracy". The role of the law should rather be to provide a mechanism by which shareholder grievances may be brought before a court, and a determination of liability made upon a standard of fairness. If the suggested amendment limiting the right of ratification is made, section 99 may provide such a tool.

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[174] Nor has the dog been thrown entirely out of the manger. "[T]here may be situations where a profit must be disgorged, although not gained at the expense of the company, on the ground that a director must not be allowed to use his position as such to make a profit even if it was not open to the company": *ibid.*, 609. But the absence of detriment to the company is presumably one of the "many factors" by which the application of the standards of "loyalty, good faith and avoidance of conflict of duty and self-interest ... must be tested": *ibid.*, 620.

[175] See N. S. Buchanan, *The Economics of Corporate Enterprise* (1940), 452 *et seq.*